

**STATE OF CALIFORNIA  
DEPARTMENT OF WATER RESOURCES  
ELECTRIC POWER FUND  
ANNUAL REPORT FOR FISCAL YEAR ENDED JUNE 30, 2002**

**PREPARED IN ACCORDANCE WITH CONTINUING  
DISCLOSURE CERTIFICATE REPORTING REQUIREMENTS  
OF THE POWER SUPPLY REVENUE BONDS**



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## Report of Independent Accountants

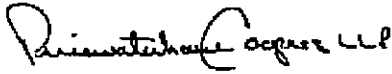
The Director of the State of California  
Department of Water Resources

In our opinion, the accompanying statements of net assets and the related statements of activities and cash flows present fairly, in all material respects, the financial position of the Department of Water Resources Electric Power Fund (Fund), a component unit of the State of California, as of June 30, 2002 and 2001, and the results of its operations and its cash flows for the year ended June 30, 2002, and the period from January 19, 2001 (date of inception) to June 30, 2001, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Fund's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As explained in Note 1 to the financial statements, the Fund is involved in certain lawsuits and regulatory proceedings that could impact the revenue requirements and rates needed to repay debt and the terms and conditions of the power purchase contracts. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

The Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurements and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 10, 2002, on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with laws and regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.



December 10, 2002

# **Department of Water Resources Electric Power Fund Management's Discussion and Analysis**

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## **HISTORY AND FINANCING**

The Department of Water Resources Electric Power Fund (Fund) was established in January 2001, in connection with the Governor of California's emergency proclamation and subsequent legislation to assist in mitigating the effect of a statewide energy supply emergency. The enabling legislation included the following powers and requirements:

- Authorization to secure and requirement to retain title to power for resale to end use customers of the State's investor owned utilities (IOUs).
- Authorization to enter into servicing arrangements with IOUs for transmission, distribution, billing and collection services.
- Entitlement to recover revenue requirements for authorized activities, including debt service, the costs of power purchases, administrative costs and reserves.
- Authorization to enter into agreements with California Public Utility Commission (CPUC) to ensure collection of revenue requirements.
- Restriction from entering into new contracts after December 31, 2002.
- Authorization to administer existing contracts after December 31, 2002.
- Authorization to issue revenue bonds not to exceed \$13.4 billion.

Additional background is provided in Note 1 to the financial statements.

The original funding for the Fund came from advances from the State's General Fund as permitted by the enabling legislation. Through June 26, 2001, advances aggregating \$6.2 billion were made to the Fund, to make payments for purchased power. There have been no additional advances since that date. In July 2001, \$116 million, the amount of cash on hand at June 26, 2001, was repaid to the General Fund.

On June 26, 2001, the Fund received net proceeds of a \$4.3 billion interim loan from a financial consortium led by JPMorgan Chase Bank. Under the terms of the Credit and Security Agreement, the loan was converted to a term loan on October 31, 2001. Principal and interest payments were made quarterly when due through October 30, 2002.

On October 30, 2002, \$4.25 billion of variable rate revenue bonds were sold. A majority of the proceeds of the sale were used to repay the remaining amounts due on the term loan, with \$163 million used to repay the General Fund. On November 14, 2002, \$7 billion in fixed rate revenue bonds were sold. A majority of the proceeds of the sale were used to repay all remaining principal due to the General Fund. All interest due to the General Fund was paid from cash on hand.

## **USING THIS REPORT**

This financial report consists of three financial statements with accompanying notes for the Fund. The Statements of Net Assets, prepared on the accrual basis of accounting, includes all assets and liabilities of the Fund. The Statements of Activities, also prepared on the accrual basis, take into account all revenues and expenses for the Fund regardless of when cash is received or paid. The Statements of Cash Flow reflect the actual cash receipts and disbursements for a specified period of time.

# **Department of Water Resources Electric Power Fund** **Management's Discussion and Analysis**

## **STATEMENT OF NET ASSETS**

The Funds assets and liabilities as of June 30, are summarized as follows (in millions):

	2002	2001
Cash and investments, including restricted cash	\$ 2,129	\$ 4,427
Recoverable costs, current portion	1,318	1,591
Other current assets	33	17
Recoverable costs, net of current portion	7,263	6,127
Total assets	<u>\$ 10,743</u>	<u>\$ 12,162</u>
Long-term debt, including current portion	\$ 10,345	\$ 10,585
Other current liabilities	398	1,577
Total capital and liabilities	<u>\$ 10,743</u>	<u>\$ 12,162</u>

Cash and investments decreased by approximately \$2.3 billion from June 30, 2001 to June 30, 2002. The balance at June 30, 2001, consisted primarily of the proceeds of the \$4.3 billion interim loan received on June 26, 2001. The decrease in cash and investments from June 30, 2001 to June 30, 2002, is attributable to a decrease in accounts payable of \$1.2 billion and payments of principal and interest on loans of \$.8 billion. The remaining \$.3 billion decrease is attributable to the excess of payments for power purchased over cash received from power sold. The majority of this decrease took place from July to October 2001. Since October 2001, cash receipts from power sales have approximated payments for the cost of power.

The current portion of recoverable costs reflects billings to the IOU customers that have not yet been collected. Through March 2002, the IOUs were permitted by a CPUC order to make payment to the Fund only for energy supplied under bi-lateral contracts and not for imbalance energy supplied through the California Independent System Operator (ISO) market. Effective April 1, 2002, the IOUs are now required to make payment to the Fund for imbalance energy. Amounts due for imbalance energy supplied from January 2001 to March 2002, were remitted to the Fund in monthly payments through September 1, 2002.

Other current assets consist primarily of interest receivable on cash and investments.

Long-term recoverable costs consist of costs that are recoverable through future billings. While the balance has increased from June 30, 2001 to June 30, 2002, the majority of this increase occurred from July to September 2001, when the cost per megawatt of power was in excess of the rate per megawatt hour that the Fund was able to charge customers of the IOUs. Currently, the recovery rate from customers is in excess of the cost of power per megawatt hour; thus this asset should be recovered over time.

Long-term debt has decreased by \$240 million through the repayment of \$116 million to the State General Fund and \$451 million on the interim loan. These two decreases are offset by accrued interest expense of \$327 million on the State General Fund advances for the year ended June 30, 2002.

## Department of Water Resources Electric Power Fund

### Management's Discussion and Analysis

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In addition to the purchase of power through both the spot market and long-term contracts, the Fund has been the creditworthy party for certain costs incurred for the benefit of two major IOUs in the ISO market. The balance in other current liabilities at June 30, 2001, is attributable to settlement problems with the ISO Market. The Fund was not billed for the ISO Market charges for January 2001 through July 2001 until November 2001, and did not begin making payments until December 2001. The Fund is now current on all payments to the ISO; therefore, other current liabilities at June 30, 2002, reflects one month's activity for the bi-lateral market and two months (the normal billing cycle) for the ISO markets, at costs per megawatt hour significantly less than were in effect at June 30, 2001.

#### REVENUES

The cost of providing energy is recoverable primarily through power sales to the customers of the IOUs. These charges are collected by the IOUs as agent for the Fund and then forwarded to the Fund daily. Charges are determined by applying a rate approved by the CPUC for each IOU to the megawatt hours delivered by the fund to each IOU's service area. Therefore, revenues are directly related to the amount of power used by customers. Interim rates were initially established by the CPUC in March 2001. Final rates for calendar years 2002 and 2001, which approximated the interim rates, were adopted by the CPUC in February 2002. The following reflects power sales and cash receipts during each period and current accounts receivable at the end of each reporting period (in millions):

	For the year ended June 30, 2002	For the period from January 19, 2001 (date of inception) to June 30, 2001
Power sales during period	\$ 4,139	\$ 2,733
Cash receipts during period	4,418	1,135
Current accounts receivable at end of period	1,318	1,591

#### EXPENDITURES

The following reflects purchases and payments during each period and accounts payable at the end of each reporting period (in millions):

	For the year ended June 30, 2002	For the period from January 19, 2001 (date of inception) to June 30, 2001
Power purchases during period	\$ 4,742	\$ 8,764
Payments during period	5,966	7,203
Accounts payable at end of period	397	1,574

## **Department of Water Resources Electric Power Fund Management's Discussion and Analysis**

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Early in the Fund's existence, energy costs were extremely high. The average cost was \$268/MWh for the period ending June 30, 2001. The monthly averages ranged from \$453/MWh in January 2001, down to \$174/MWh in June 2001. The average cost for the year ended June 2002, was \$109/MWh and the monthly averages have ranged from \$71/MWh to \$125/MWh. The monthly average cost for June 2002, was \$84/MWh.

The Fund began operations in January 2001, and had no long-term contracts in place; therefore, over 90% of the Fund's energy purchases in the period ended June 30, 2001, were made in the spot market. For the year ended June 30, 2002, approximately 22% of the energy purchases were made in the spot market as the Fund has been able to enter into long-term power purchase contracts, ranging from one to eleven years. The long-term contracts and declining spot market prices, which began in June 2001, helped to drive down the average cost of energy for the year ended June 30, 2002, compared to the period ended June 30, 2001.

Payments made under the long-term power contracts approximated \$2.5 billion and \$1.1 billion for the year ended June 30, 2002, and for the period from January 19, 2001 (date of inception) to June 30, 2001, respectively. The amounts of fixed obligations under the long-term contracts as of June 30, 2002 and June 30, 2001, totaled \$24.3 and \$31.7 billion, respectively. In addition to the fixed costs, there are variable costs associated with several of the contracts, such as the cost of natural gas. Management expects that the amount of variable obligations associated with long-term power purchase contracts to approximate \$8 billion. DWR has been renegotiating some of the contracts in order to improve reliability, procure more dispatchable power, increase the number of contracts that are assignable to the IOUs, and reduce cost. During the year ended June 30, 2002, 17 contracts were renegotiated, reducing the future fixed obligations by approximately \$4.5 billion. Subsequent to June 30, 2002, three additional contracts have been renegotiated, resulting in additional future savings of \$67 million.

Generally, the terms of payment under the power purchase contracts require the Fund to pay by the 20<sup>th</sup> of the month following delivery of power. Through June 2001, the Fund often made payment on an expedited basis because of suppliers' concerns about the newness of the Fund, the Fund's ability to make timely payments, and the size of the energy purchases. All payments were made on time, thus accounts payable for bi-lateral purchases of power have always been kept at minimal levels.

### **FUTURE OF THE FUND**

The Fund will administer the revenue bonds until such time as the bonds are completely redeemed. Revenue requirements for the repayment of the bonds will be determined at least annually by the Fund and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to set rates for the customers of the IOUs such that the Fund will always have monies to retire the debt when due.

The Fund has the authority to manage all contracts entered into before December 31, 2002, for the life of the contracts. Revenue requirements for the payment of energy purchased under the long-term contracts will be determined at least annually by the Fund and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to implement rates such that the Fund will receive necessary monies to pay for energy purchased.



## **Department of Water Resources Electric Power Fund Management's Discussion and Analysis**

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The Fund is proceeding with a transition process that could transfer the scheduling and ultimately the financial responsibility for the contracts to the IOUs. However, there are a number of issues to be addressed, including the assignment of the long-term contracts to the IOUs, which could affect the timing of the transition process.

**Department of Water Resources Electric Power Fund****Statements of Net Assets****June 30, 2002 and 2001****(in millions)**

	2002	2001
<b>Assets</b>		
Current assets:		
Cash and investments	\$ 2,119	\$ 4,241
Restricted cash on deposit with agent	-	186
Other investments	10	-
Recoverable costs, current portion	1,318	1,591
Interest receivable	32	10
Due from other funds	1	7
Total current assets	<u>3,480</u>	<u>6,035</u>
Recoverable costs, net of current portion	7,263	6,127
Total assets	<u>\$ 10,743</u>	<u>\$ 12,162</u>
<b>Capitalization and Liabilities</b>		
Capitalization:		
Long-term debt, less current maturities:		
Advances from State General Fund including accrued interest of \$402 and \$75, net of current portion	\$ 6,496	\$ 6,169
Term loan	<u>3,849</u>	<u>3,909</u>
Total capitalization	<u>10,345</u>	<u>10,078</u>
Current liabilities:		
Accounts payable	397	1,574
Current portion of advances from State General Fund	-	116
Current portion of term loan	-	391
Accrued interest on term loan	<u>1</u>	<u>3</u>
Total current liabilities	<u>398</u>	<u>510</u>
Commitments and Contingencies (Notes 1 and 6)		
Total capitalization and liabilities	<u>\$ 10,743</u>	<u>\$ 10,588</u>

The accompanying notes are an integral part of these financial statements.

**Department of Water Resources Electric Power Fund****Statements of Activities****For the year ended June 30, 2002, and****for the period from January 19, 2001****(date of inception) to June 30, 2001****(in millions)**

	<b>For the year ended June 30, 2002</b>	<b>For the period from January 19, 2001 (date of inception) to June 30, 2001</b>
Operating revenues:		
Power sales	\$ 4,139	\$ 2,733
Total operating revenues	<u>4,139</u>	<u>2,733</u>
Operating expenses:		
Power purchases	4,742	8,764
Administrative expenses	47	13
Deferral of operating expenses	<u>(1,136)</u>	<u>(6,127)</u>
Total operating expenses	<u>3,653</u>	<u>2,650</u>
Income from operations	486	83
Costs incurred in anticipation of sale of long-term bonds	(26)	(15)
Interest income	102	10
Interest expense	<u>(562)</u>	<u>(78)</u>
Net income	-	-
Net assets, beginning of period	-	-
Net assets, end of period	<u>\$ -</u>	<u>\$ -</u>

The accompanying notes are an integral part of these financial statements.

**Department of Water Resources Electric Power Fund**  
**Statements of Cash Flows**  
**For the year ended June 30, 2002, and**  
**for the period from January 19, 2001**  
**(date of inception) to June 30, 2001**

(in millions)

	For the year ended June 30, 2002	For the period from January 19, 2001 (date of inception) to June 30, 2001
Cash flows from operating income:		
Receipts from customers	\$ 4,418	\$ 1,135
Payments for power purchases and other costs	(5,966)	(7,203)
Net cash used in operating activities	(1,548)	(6,068)
Cash flows from non-capital financing activities:		
(Payments on) proceeds from term loan	(451)	4,300
(Payments to) advances from State of California General Fund	(116)	6,210
Payment of financing costs	(26)	(15)
Payment of interest on interim loan	(237)	-
Net cash (used in) provided by non-capital financing activities	(830)	10,495
Cash flows from investing activities:		
Investments purchased	(10)	-
Interest received on investments	80	-
Net cash provided by investing activities	70	-
Net (decrease) increase in cash and investments	(2,308)	4,427
Cash and investments, beginning of period	4,427	-
Cash and investments, end of period	\$ 2,119	\$ 4,427
Reconciliation of operating income to net cash used in operating activities:		
Income from operations	\$ 486	\$ 83
Changes in net assets and liabilities to reconcile operating income to net cash used in operations:		
Recoverable costs	(863)	(7,718)
Due from other funds	6	(7)
Accounts payable	(1,177)	1,574
Total adjustments	(2,034)	(6,151)
Net cash used in operating activities	\$ (1,548)	\$ (6,068)

The accompanying notes are an integral part of these financial statements.

**Department of Water Resources Electric Power Fund**  
**Notes to Financial Statements**  
**For the year ended June 30, 2002, and**  
**for the period from January 19, 2001**  
**(date of inception) to June 30, 2001**

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**1. Reporting Entity**

**Background**

In January 2001, the Governor of California issued an emergency proclamation directing the Department of Water Resources (DWR) to enter into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency.

The Department of Water Resources Electric Power Fund (a component unit of the State of California) (Fund) was established on January 19, 2001, by Senate Bill 7 from the First Extraordinary Session of 2001 (SB7X). Assembly Bill 1 from the First Extraordinary Session of 2001 (AB1X), enacted on February 1, 2001, added Division 27 to the California Water Code to clarify and expand the powers of DWR to incur debt for the purposes of the Fund and to use amounts in the Fund for the purchase of power. The Fund is administered by DWR. Division 27 of the California Water Code (as subsequently amended by Senate Bill 31 from the First Extraordinary Session of 2001) includes the following powers and requirements:

- Authorizes DWR to act on behalf of the State of California to secure necessary power supplies for resale to customers of Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE), and San Diego Gas & Electric Company (SDG&E) (collectively referred to as the investor owned utilities or IOUs).
- Requires DWR to retain title to all power sold, but authorizes DWR to enter into service agreements with the IOUs for transmission, distribution, billing and collection services.
- Authorizes DWR and the California Public Utilities Commission (CPUC) to enter into an agreement with respect to charges to provide for recovery by DWR of its revenue requirements.
- Authorizes DWR to issue bonds in an amount not to exceed \$13.4 billion and payable solely from the Fund, and to deposit the proceeds of the bonds in the Fund for use for any of the purposes of the Fund.
- Entitles DWR to recover its revenue requirements incurred in connection with its authorized activities, including debt service, the costs of power purchases, administrative costs and reserves.
- Restricts DWR from entering into new power purchase agreements after December 31, 2002, but allows DWR to continue to administer existing contracts and enforce revenue requirements beyond that date.

The Fund is proceeding with a transition process that could transfer the scheduling and ultimately the financial responsibility for the contracts to the IOUs. However, there are a number of issues to be addressed, including the assignment of the long-term contracts to the IOUs, which could affect the timing of the transition process.

DWR began selling electricity to approximately ten million retail customers in California in January 2001. DWR purchases power from wholesale suppliers under long-term contracts and in short-term and spot market transactions. DWR power is delivered to the customers

## **Department of Water Resources Electric Power Fund**

### **Statements of Cash Flows**

**For the year ended June 30, 2002, and**

**for the period from January 19, 2001**

**(date of inception) to June 30, 2001**

**(in millions)**

through the transmission and distribution systems of the IOUs and payments from the customers are collected for DWR by the IOUs pursuant to servicing arrangements approved and/or ordered by the CPUC. DWR has financed its power purchases with advances from the General Fund of the State of California, loans from financial institutions, and revenues from power sales to customers.

#### **Litigation and Uncertainties**

DWR is involved in several lawsuits and regulatory proceedings. In one action, PG&E contested the determination of DWR's revenue requirement submissions for calendar years 2001 and 2002 to the CPUC as just and reasonable. The Court found that DWR had failed to follow the California Administrative Procedures Act (APA) and ordered DWR to do so. The Court also ruled that its decision did not affect any action taken by the CPUC, including the implementation of cost recovery of DWR's calendar years 2001 and 2002 revenue requirements. DWR has filed its 2003 and amended 2001-2002 revenue requirements with the CPUC, following APA requirements in the internal development of its revenue requirements. On October 21, 2002, PG&E filed a lawsuit on the 2003 revenue requirements claiming that DWR had not adequately followed APA requirements.

In another matter, two energy suppliers have petitioned the Federal Energy Regulatory Commission, contending that amounts totaling \$58 million are owed by DWR for power purchased in the last half of January 2001, by DWR on behalf of PG&E and SCE in the California Independent System Operator (ISO) market. DWR maintains that the Fund has remitted the appropriate payments to the ISO for distribution to the energy suppliers. ISO distributed the Fund's January payment on a pro-rata basis to all market participants for the entire month although DWR purchased power on behalf of the two IOUs beginning in late January. As a result, energy suppliers did not receive full payment for the amounts owed them for power purchased in January by DWR on behalf of the two IOUs. FERC has not announced when it will rule on this matter or whether it will require DWR to make additional payments to ISO.

Additionally, various actions are underway contesting certain long-term power contracts entered into by DWR.

There are a number of other lawsuits and regulatory proceedings in which DWR is not a party but may be affected by the result because of potential impacts on the price or supply of energy in California. In one case, California Power Exchange Corporation (CalPX), certain IOUs and others have brought suit against the State of California claiming that the State's commandeering of CalPX's block forward contracts after CalPX filed bankruptcy in early 2001 was unconstitutional. The plaintiffs argue that they are entitled to damages of \$1.1 billion, which is their estimation of the fair value of the block forward contracts at the time of commandeering. Under the block forward contracts, which expired in December 2001, the Fund paid approximately \$350 million for energy provided by the contracts.

# **Department of Water Resources Electric Power Fund**

## **Statements of Cash Flows**

**For the year ended June 30, 2002, and**

**for the period from January 19, 2001**

**(date of inception) to June 30, 2001**

**(in millions)**

These lawsuits and regulatory proceedings could impact the revenue requirements and rates needed to repay debt and the terms and conditions of the power purchase contracts (Note 6). Management believes that the existing lawsuits and regulatory proceedings will be resolved in calendar year 2003. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

## **2. Summary of Significant Accounting Policies**

### **Basis of Presentation**

The Fund is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The Fund uses the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. As allowed by governmental accounting standards, the Fund has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenses.

### **Cash and Investments**

Cash and investments, for purposes of the statements of cash flows, includes cash on hand and amounts in short-term investments, including restricted cash on deposit with agent. Amounts in short-term investments include deposits in the State of California Pooled Money Investment Account-Surplus Money Investment Fund (SMIF).

Cash not required for current use is invested in SMIF. SMIF has an equity interest in the State of California Pooled Money Investment Account (PMIA). The investments in PMIA are carried at fair value, which approximates amortized cost. Generally, the investments in PMIA are available for withdrawal on demand.

PMIA funds are on deposit with the State's Centralized Treasury System and are managed in compliance with the California Government Code, according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. These investments consist of U.S. government securities, securities of federally-sponsored agencies, U.S. corporate bonds, interest bearing time deposits in California banks, prime-rated commercial paper, bankers' acceptances, negotiable certificates of deposit, repurchase and reverse repurchase agreements. The PMIA policy limits the use of reverse repurchase agreements subject to limits of no more than 10% of PMIA. The PMIA does not invest in leveraged products or inverse floating rate securities. The PMIA cash and investments are recorded at amortized cost, which approximates market.

The investment in PMIA, an investment pool managed by the State of California, does not meet the criteria to require risk categorization.

## **Department of Water Resources Electric Power Fund**

### **Statements of Cash Flows**

**For the year ended June 30, 2002, and  
for the period from January 19, 2001  
(date of inception) to June 30, 2001**

**(in millions)**

#### **Restricted Cash on Deposit with Agent**

Restricted cash on deposit with agent consists of pre-funded interest costs associated with the term loan. The cash was held by JPMorgan Chase Bank as agent for the lenders and was used to pay interest through December 31, 2001, with the remaining balance used to reduce the term loan by \$66 million in March 2002.

#### **Other Investments**

During the year ended June 30, 2002, the Fund established a brokerage account with a national brokerage house in order to take positions in futures and options so as to hedge natural gas fuel costs. Natural gas future and option agreements are reported at fair value on the balance sheet. The Department does not enter into natural gas future and option agreements for trading purposes, but rather to take advantage of favorable pricing. The Fund is exposed to risk of nonperformance if the counter parties default or if the future or option agreements are terminated. At June 30, 2002, the Fund's position underlying open natural gas future and option agreements totaled \$.4 million.

The brokerage house requires that the Fund maintain a security deposit, which is invested in compliance with the California Government Code. These funds are invested in money market mutual funds and government bonds and are carried at fair value. The investment in money market mutual funds amounted to \$7.2 million at June 30, 2002, and is not subject to risk categorization. The investment in government bonds amounted to \$2 million at June 30, 2002, and is considered a Category 1 investment that is insured or registered or for which the securities are held by the Fund or its agent in the Fund's name.

#### **Revenues and Recoverable Costs**

The cost of providing energy is intended to be recovered through charges to the customers of three investor owned utilities and other entities as allowed by AB1X and regulated by the CPUC. Revenues are recognized when energy is delivered to the customers. The billings cover debt service, the costs of power purchases, administrative costs and reserves. These costs are recovered over a period of time as determined by the rate making process between DWR and the CPUC through the IOU's billings to the customers.

For the year ended June 30, 2002, and for the period from January 19, 2001 (date of inception) to June 30, 2001, the billings were reduced by \$221 million and \$64 million, respectively, for rebates given to the customers of the IOUs under the Governor's "20-20 Energy Rebate Program," which, during the summer peak demand months, generally granted the customers a 20% reduction in their monthly power bills if they reduced their energy use by 20% from the same period in the previous year. These reductions extend the period of time over which the Fund will recover its costs.

Amounts that have been earned but not collected are recorded as the current portion of recoverable costs. Costs that are recoverable through future billings are recorded as long-term.



**Department of Water Resources Electric Power Fund**  
**Statements of Cash Flows**  
**For the year ended June 30, 2002, and**  
**for the period from January 19, 2001**  
**(date of inception) to June 30, 2001** (in millions)

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**3. Cash and Investments**

Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and approximated 3.42% and 5.73% at June 30, 2002 and 2001, respectively. For the year ended June 30, 2002, and for the period from January 19, 2001 (date of inception) to June 30, 2001, interest earned on the deposit in PMIA was \$99 million and \$10 million, respectively.

**4. Long-Term Debt**

**Advances from State General Fund**

In conjunction with the Governor's emergency proclamation in January 2001, approximately \$302 million of DWR general fund appropriations were expended for energy purchases. SB7X appropriated an additional \$400 million for the Fund on January 19, 2001. AB1X appropriated an additional \$500 million on February 1, 2001, and provided for additional appropriations upon a 10-day notice to the Legislature. Through June 30, 2001, the total AB1X appropriations transferred from the State of California General Fund to the Fund were \$5.508 billion. There have been no additional appropriations through June 30, 2002. As of June 30, 2002 and June 30, 2001, a total of \$6.094 billion and \$6.210 billion, plus interest, respectively, was due to the General Fund. The \$116 million cash balance in the Fund at the time the interim loan described below was implemented was transferred back to the General Fund in July 2001, and was therefore recorded as a current liability at June 30, 2001. The remaining amount due the General Fund is recorded as a long-term obligation because the amount due the General Fund was refinanced with revenue bonds issued in October and November 2002, as described in Note 8. The first payment of principal on the revenue bonds will not occur until 2004.

Interest on the advances from the General Fund is calculated at the lesser of the stated PMIA interest rate in effect on the date preceding each appropriation from the General Fund or the average of the annual rate for the three preceding fiscal years. The average interest rate on advances approximated 5.31% and 5.64% at June 30, 2002 and 2001, respectively. For the year ended June 30, 2002, and the period from January 19, 2001 (date of inception) to June 30, 2001, interest expense on the advances from the General Fund was \$327 million and \$75 million, respectively.

**Term Loan**

On June 26, 2001, the Fund received an interim loan from a financial consortium lead by JPMorgan Chase Bank. The net proceeds from the interim loan, equal to \$4.3 billion gross proceeds less \$194 million in origination fees, pre-funded interest, and other costs, were used to fund power purchases. The interim loan was structured with taxable and tax-exempt components of \$2.3 billion and \$2.0 billion, respectively, and is payable from revenues. The interim loan was collateralized by revenues described in Note 2 and investment income. The financing was structured as a term loan due to be paid on or before October 31, 2001, from the proceeds of the sale of long-term bonds. As bonds were not issued before October 31, 2001, the interim financing converted to a three-year term loan with quarterly principal and

## **Department of Water Resources Electric Power Fund**

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**(In millions)**

interest payments. DWR made principal payments of \$451 million during the year ended June 30, 2002. The term loan was paid off with bond proceeds in October 2002, as discussed in Note 8.

For both the year ended June 30, 2002, and for the period from January 19, 2001 (date of inception) to June 30, 2001, interest on the term loan averaged 5.7% and 5.1%, respectively.

#### **5. Retirement Plan**

##### **Plan Description**

The State of California is a member of the California Public Employees' Retirement System (PERS), an agent multiple-employer pension system that provides a contributory defined-benefit pension for substantially all State employees. DWR is included in the State Miscellaneous Category (Tier 1 and Tier 2) within PERS, thereby limiting the availability of certain System pension data. PERS functions as an investment and administrative agent for participating public agencies within the State of California. Departments and agencies within the State of California, including DWR, are in a cost-sharing arrangement in which all risks and costs are shared proportionately by participating State agencies. Copies of PERS' comprehensive annual financial report may be obtained from their executive office at 400 P Street, Sacramento, California 95814.

The pension plan provides retirement benefits, survivor benefits, and death and disability benefits based upon employee's years of credited service, age and final compensation. Vesting occurs after five years of credited service except for second tier benefits, which require ten years of credited service. Employees who retire at or after age 50 with five or more years of service are entitled to a retirement benefit, payable monthly for the remainder of their lives. Several survivor benefit options which reduce a retiree's unmodified benefit are available. Benefit provisions and all other requirements are established by state statute.

##### **Annual Pension Cost**

For both the year ended June 30, 2002, and for the period from January 19, 2001 (date of inception) to June 30, 2001, DWR's pension cost and actual contribution allocated to the Fund based on the Fund's payroll costs amounted to less than \$1 million.

#### **6. Commitments and Contingencies**

##### **Commitments**

DWR has entered into long-term power purchase contracts ranging from one to eleven years. Payments made under these contracts approximated \$2.5 and \$1.1 billion for the year ended June 30, 2002, and for the period from January 19, 2001 (date of inception) to June 30, 2001, respectively.

## Department of Water Resources Electric Power Fund

### Statements of Cash Flows

For the year ended June 30, 2002, and

for the period from January 19, 2001

(date of inception) to June 30, 2001

(in millions)

The amounts of fixed obligations under the long-term contracts as of June 30, 2002, are as follows:

For the year ending June 30,	Fixed Obligation (in millions)
2003	\$ 3,405
2004	3,219
2005	3,069
2006	2,821
2007	2,618
Thereafter	9,118
	<u>\$ 24,250</u>

In addition to the fixed costs there are variable costs associated with several of the contracts. Management expects that the amount of fixed and variable obligations associated with long-term power purchase contracts to approximate \$32 billion as of June 30, 2002. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and costs of natural gas:

- a. Dispatchable contracts: Dispatchable contracts provide DWR with the ability to call on more energy as required. The total amount of fixed and variable obligations associated with long-term power purchase contracts is based on the forecasted dispatch of these contracts to meet the forecasted IOU load. The variability of energy requirements fluctuate with the weather (on hot summer days with heavy air conditioner usage, energy requirements can increase substantially over forecasted amounts).
- b. Gas prices: Many of the contracts contain a pass through component whereby DWR has the ability to purchase the natural gas that is used to power the generating plants. The total amount of fixed and variable obligations associated with long-term power purchase contracts is based on forecasted natural gas prices used in the modeling of these contracts. Natural gas prices are subject to market forces and so will vary throughout the duration of the contracts.

DWR has been renegotiating some of the contracts in order to improve reliability, procure more dispatchable power, increase the number of contracts that are assignable to the IOUs, and reduce cost. During the year ended June 30, 2002, 17 contracts were renegotiated, reducing the future fixed obligations by approximately \$4.5 billion. Subsequent to June 30, 2002, three additional contracts were renegotiated, reducing future fixed obligations by an approximate \$67 million.

#### Contingencies

The Fund is self-insured for most risks, including general liability and workers' compensation. Management believes that any costs associated with such losses are recoverable from the customers of the IOU's.

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**7. Related Party Transactions**

During the year ended June 30, 2002, and the period from January 19, 2001 (date of inception) to June 30, 2001, the Fund purchased power approximating \$11 million and \$80 million, respectively, from the State Water Resources Development System, another enterprise fund administered by DWR.

**8. Subsequent Events**

On October 30, 2002, the Fund issued \$4.25 billion of variable rate revenue bonds. On November 14, 2002, the Fund issued \$6.31 billion in fixed rate tax-exempt revenue bonds and \$.70 billion in fixed rate taxable revenue bonds. The proceeds of the bonds, along with the then cash balance in the Fund were used to repay previous debt and establish separate accounts in the Fund as required by the Bond Indenture. Sources and uses of funds from the issuance of the revenue bonds are as follows (in millions):

**Sources of funds:**

Proceeds from issuance of fixed rate revenue bonds, including premium and accrued interest	\$ 7,425
Proceeds from issuance of variable rate revenue bonds	4,250
Cash balance at time of issuance of fixed rate bonds	2,102
Total sources	<u>\$ 13,777</u>

**Uses of funds:**

Repay term loan, including accrued interest of \$16 million	\$ 3,480
Repay General Fund, including accrued interest of \$525 million	6,620
Pay costs of issuance, underwriter's discounts, and bond insurance premiums	286
Establish specific accounts as required by the Bond Indenture:	
Operating account	1,116
Priority contract payment account	308
Operating reserve account	777
Bond charge collection account	47
Bond charge payment account	216
Debt service reserve account	927
Total uses	<u>\$ 13,777</u>

The variable rate bonds have an interest rate of 1.8% through early January 2003, at which time the bonds will convert to 35-day auction rate bonds or variable rate demand bonds whose interest rates are set either daily or weekly. The variable rate bonds have a final stated maturity of 2022 but will be retired in sinking fund installments from 2005 to 2022.

# **Department of Water Resources Electric Power Fund**

## **Statements of Cash Flows**

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**for the period from January 19, 2001**

**(date of inception) to June 30, 2001**

**(in millions)**

The Fund entered into interest-rate swap agreements to pay fixed rates of interest and receive floating rate payments. Certain swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled and/or anticipated reductions in the associated "bonds payable" category. The swap agreements are expected to reduce interest-rate risk associated with variable-rate bonds issued by the Fund. The Fund is exposed to potential loss in the event that the counter parties are unable to perform to the terms of the agreements. However, the Fund does not anticipate nonperformance by the counter parties.

Interest rates on the fixed rate bonds, which have a maximum maturity of 20 years, range from 3% to 6%.

## Summary of Operating and Financial Results

### Department of Water Resources Power Charge Accounts Year Ended December 31, 2002

		(\$millions)
BEGINNING BALANCE		
Operating Account		\$ 2,574
Total Beginning Balance		<u>2,574</u>
OPERATING REVENUES AND EXPENSES		
Operating Revenues <sup>1</sup>		4,953
Power Costs <sup>2</sup>		(4,520)
Other Operating Expenses		(99)
Net Operating Revenues		<u>334</u>
OTHER FINANCIAL RESOURCES (DEBT)		
Interim Loan Debt Service Payments		(1,004)
Net Revenue Bond Proceeds Attributable to Power Charge Accounts		10,247
Interim Loan and State General Fund Loans Repayment		(10,084)
Net Other Financial Resources (Debt)		<u>(841)</u>
NET CHANGE IN ACCOUNT BALANCES		<u>(507)</u>
ENDING ACCOUNT BALANCES		
Operating Account	1,269	
Priority Contract Account	21	
Operating Reserve Account	<u>777</u>	<u>\$ 2,067</u>

NOTES:

1. There were no Direct Access Surcharge Revenues during Calander Year 2002.
2. Power Costs include a Residual Net Short costs of \$379 million. Residual Net Short consists of Investor Owned Utilities' (IOU) demand requirements remaining after Priority Contracts are applied to the total Net Short.

### Department of Water Resources Bond Charge Accounts Year Ended December 31, 2002

		(\$millions)
INITIAL TRANSFERS FROM THE BOND SALE		
Bond Charge Collection Account		\$ 47
Bond Charge Payment Account		216
Debt Service Reserve Account		927
Total Balance Transferred from the Bond Sale		<u>1,190</u>
REVENUES, TRANSFERS, AND EXPENSES		
Bond Charge Revenue		<u>32</u>
NET CHANGE IN ACCOUNT BALANCES		<u>32</u>
ENDING ACCOUNT BALANCES		
Bond Charge Collection Account	79	
Bond Charge Payment Account	216	
Debt Service Reserve Account	<u>927</u>	<u>\$ 1,222</u>

## Estimated Average Power Charges and Bond Charges to the Customers

The following table provides a summary of average power charges and bond charges for the year ended December 31, 2002. The Power Charges shown are based on the Retail Revenue Requirements as submitted to the California Public Utilities Commission. The revenues from Bond Charges vary by Investor Owned Utility (IOU).

### ESTIMATED AVERAGE POWER CHARGES

Year	Retail Revenue Requirements (Millions)	DWR Energy Deliveries (GWh)	Power Charges (\$/MWh)
2002	\$ 4,648	36,994	\$ 126

### ESTIMATED AVERAGE BOND CHARGES<sup>1</sup>

Year	Bond Charge Revenues (Millions)	Total Customer Energy (GWh)	Bond Charges <sup>2</sup> (\$/MWh)
2002	\$ 52	\$ 8,354	\$ 6.22

1. Bond Charges did not start accruing until November of 2002.

2. Effective December 4, 2002, the Bond Charge Rate was increased from \$5.25/MWh to \$7.01/MWh and baseline usage below 130% became exempt.

## Department Staffing

To meet its obligations under AB1X, the Department established a functional division, California Energy Resource Scheduling (CERS), which operates its Power Supply Program. As of December 31, 2002, CERS' staffing consisted of 54 permanent staff, 22 contract employees, 47 consulting advisors, and 5 employees on loan from other departments within the State government.

## Additional Information

In complying with the restriction to not enter into new power purchase agreements after December 31, 2002, effective January 1, 2003, the Department is no longer purchasing short-term and spot market power. In addition, the Department has transferred the scheduling and settlement functions for the long-term contracts to the IOUs. Ultimately the financial responsibility for the long-term contracts may be transferred to the IOUs as part of a complete assignment of the contracts and release of the Department. However, there are a number of issues to be addressed, including IOU creditworthiness and counter-party approval before the contracts can be assigned.